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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

REPORT AND RECOMMENDATION

OF THE

PRESIDENT

TO THE

EXECUTIVE DIRECTORS

ON A

PROPOSED LOAN

TO THE

KOREA DEVELOPMENT FINANCE CORPORATION

WITH THE GUARANTEE

OF THE

REPUBLIC OF KOREA

April 13, 1971

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

REPORT AND RECOMMENDATION OF THE PRESIDENT
TO THE EXECUTIVE DIRECTORS ON A PROPOSED LOAN TO
THE KOREA DEVELOPMENT FINANCE CORPORATION
WITH THE GUARANTEE OF THE REPUBLIC OF KOREA

1. I submit the following report and recommendation on a proposed loan in an amount in various currencies equivalent to \$30 million to the Korea Development Finance Corporation (KDFC), to be guaranteed by the Republic of Korea.

PART I - HISTORICAL

2. The very high growth rate of the manufacturing sector, averaging annually 22% during the last five years, has created a large demand for long-term industrial financing. KDFC was established in April 1967 with the assistance of the Bank Group to provide urgently needed industrial financing on reasonable terms to the private sector. KDFC's initial capitalization, including equity investments by IFC, domestic and foreign private investors and a long-term Government loan, was completed in February 1968, when the Company received a \$5 million loan from the Bank and a \$5 million loan from U.S. AID (later reduced to \$3 million). A second Bank loan of \$20 million was approved in June 1969, and is likely to be fully committed by June 1971. The proposed third loan of \$30 million is expected to meet about three-quarters of KDFC's requirements for foreign exchange until the end of 1972.

3. Loan negotiations were held in Washington from March 22 to March 26, 1971. The Borrower was represented by KDFC's President, Mr. C.H. Kim. The Guarantor was represented by Mr. K.H. Kim from the Economic Planning Board.

4. The proposed loan would be the fifth Bank loan to Korea, bringing the total amount of Bank lending to \$140 million. Korea has received six IDA credits totalling \$65.0 million. Before the end of this fiscal year, I expect to submit a recommendation for a Bank loan of about \$40 million for a highway construction project. The first operation in the next fiscal year will be an IDA credit for an agricultural credit project.

5. The following is a summary statement of Bank loans and IDA credits as of March 31, 1971:

Loan or Credit No.	Year	Borrower	Purpose	Amount (U.S. \$ million)		
				Bank	IDA	Undisbursed
25	1962	Republic of Korea	Railway		14.0	-
110	1967	Republic of Korea	Railway		10.7	-
529	1968	KDFC	Dev. Fin. Co.	5.0		0.2
S-4	1968	Republic of Korea	Highway Studies		3.5	1.0
600	1969	ADC	Irrigation	45.0		43.9
151	1969	Republic of Korea	Education		14.8	14.7
622	1969	KDFC	Dev. Fin. Co.	20.0		13.4
669	1970	Republic of Korea	Railway	40.0		39.7
183	1970	Republic of Korea	Railway		15.0	14.9
234 ^{1/}	1971	Republic of Korea	Livestock		7.0	7.0
Total (less cancellations)				110.0	65.0	134.8
of which has been repaid						
to the Bank and others				0.1		
Total now outstanding				109.9		
Amount sold				0.8		
of which has been repaid				-	0.8	
Total now held by Bank and IDA				109.1	65.0	
Total undisbursed				97.2	37.6	134.8

^{1/} Not yet effective

6. Disbursements of the irrigation loan are behind schedule because it took longer than expected for the borrower to employ consultants, and because the original borrower was succeeded by a new organization about whose competence the Bank had to satisfy itself. Three major contracts have now been awarded and disbursements to cover civil works and equipment expenditures can be expected to pick up within the next few months. Additional major civil works contracts are expected to be awarded in the second half of 1971. The appointment of consultants under the education credit was also delayed and this held up design work. However, work is now well under way and disbursements for construction and equipment should start in the near future. Disbursements under the credit for highway studies and the railway loan and credit are progressing satisfactorily.

7. IFC has made the following investments:

	U.S. \$ million	
	Loans	Shares
1968 KDFC		0.7
1969 Honam Silk Co.	1.4	0.3
1970 Atlas Paper Co.	4.5	0.5

Present holdings amount to \$7.4 million in loans and shares. Further possibilities are being investigated.

PART II - DESCRIPTION OF THE PROPOSED LOAN

8. Borrower: Korea Development Finance Corporation (KDFC)
- Guarantor: Republic of Korea
- Amount: Various currencies equivalent to
 \$30 million
- Purpose: To enable KDFC to finance the foreign
 exchange costs of specific projects
 undertaken by private industrial enter-
 prises in Korea
- Amortization: In 14 years including a 2½ year period
 of grace, through semi-annual install-
 ments beginning March 15, 1974 and
 ending March 15, 1985. The Bank and
 KDFC will from time to time change the
 amortization schedule to conform sub-
 stantially to the aggregate of amortiza-
 tion schedules for sub-loans and invest-
 ments for which withdrawals from the
 Loan Account have been approved.
- Interest Rate: 7½% per annum
- Commitment Charge: 3/4 of 1% per annum

PART III - THE PROJECT

9. A report entitled "Appraisal of Korea Development Finance Corporation" (DB-76a) dated April 12, 1971 is attached.
10. Manufacturing has been the fastest growing sector of the Korean economy, increasing its share in the GNP during the past ten years from 14% to 26%. Exports have been increasing at an annual average rate of about 40% during the past few years, with exports of manufactured goods growing at nearly 50% a year. The share of manufactured goods in total exports is about 80%, with textiles, machinery and plywood leading the way.
11. Industry in Korea is predominantly privately-owned, with the Government owning only about 5% of the total capital invested in manufacturing. Commercial and development banks from which businessmen can borrow funds are limited in number and resources, causing many enterprises to turn to the expensive curb market for short-term local funds, and to suppliers' credits and short-term foreign commercial bank loans for foreign exchange. The commercial banks, predominantly Government-

controlled, rarely lend on terms exceeding one year. In addition to KDFC, only the Korea Development Bank (KDB) and the Medium Industry Bank (MIB) provide medium and long-term financing for industrial ventures. The KDB and the MIB are both Government-controlled, and finance projects in both the private and public sectors, usually to further specific Government programs and policies.

12. As of December 31, 1970 KDFC's total resources amounted to \$43.1 million, consisting of share capital and retained earnings, the Government subordinated loan, an AID loan and two Bank loans. Total commitments for loans and equity investments, as of the end of last year, were the equivalent of about \$32 million, of which foreign exchange commitments amounted to \$24 million. Total disbursements by KDFC of about \$10 million equivalent in 1970 represented 2.7% of the estimated gross domestic fixed capital investment in manufacturing, and its outstanding portfolio at year end equalled about 10% of the estimated total amount of outstanding loans for industrial capital goods in Korea. While KDFC's quantitative contribution to industrial financing is relatively small, the company has made a significant qualitative contribution to economic development in Korea by introducing a modern outlook in industrial investment and by the educational impact of its project appraisals.

13. KDFC's portfolio is well diversified among textiles, paper products, rubber tires and other mainly export-oriented enterprises. As KDFC does not lend for working capital, and requires its clients to put up at least one-third of total project costs, the greater part of its financing has been for foreign exchange expenditures. In 1970, foreign currency financing represented slightly more than 70% of its total loans and investments.

14. KDFC's total foreign exchange resources, amounting to \$28 million as of the end of last year, are expected to be fully committed soon. Commitments of foreign exchange for 1971 and 1972 are projected at slightly over \$40 million. Apart from the proposed \$30 million Bank loan, KDFC has obtained a \$5 million loan from Caterpillar Far East Ltd. tied to purchases of Caterpillar equipment, and is trying to obtain additional funds from sources in Europe and Japan.

15. Uncommitted local currency resources, presently about W1.9 billion (\$6 million equivalent), together with repayments and retained earnings, should be sufficient to meet the demand on KDFC for local cost financing up to the end of 1972. However, KDFC plans share capital increases for the first half of 1972 and 1973. The first issue, together with stock issues in February 1971 and 1972, will increase KDFC's present paid-in capital of W1.64 billion (\$5.2 million equivalent) to the full amount of its authorized capital, W2.7 billion or \$8.5 million equivalent. Thereafter KDFC plans to increase the authorized capital to about W5 billion and to make a further share issue of about W675 million (\$2.1 million equivalent) in 1973.

16. Because of the undeveloped state of the capital and money markets in Korea, KDFC, with the support of the Government, is taking the lead in establishing a new financial institution. Such an institution could make a very useful contribution by developing a market for short-term commercial paper; it could help private enterprises raise equity funds through underwriting arrangements, and could create a secondary market for the securities which it underwrote. KDFC plans to subscribe 25% of the equity of the new institution, to be called the Korea Investment Corporation (KIC), and the Government has requested an IFC participation. IFC is working on this proposal with KDFC and the Government.

17. KDFC's financial position is sound. Reserves and retained earnings increased from 40% of share capital in 1968 to 85% as of the end of 1970. Net profits for 1970 were W604 million (\$1.9 million equivalent), an increase of 16% over the previous year. In 1969 and 1970 KDFC declared a 20% dividend (10% in cash, 10% in shares) and plans to do the same for the next few years.

18. KDFC's management is strong and its staff competent. The Bank's experience with KDFC has been satisfactory and it is recommended that, under the proposed loan, KDFC be authorized to approve individual subloans up to \$500,000 without the prior approval of the Bank, subject to an aggregate limit of \$7.5 million.

PART IV - LEGAL INSTRUMENTS AND AUTHORITY

19. The draft Loan Agreement between the Bank and the Korea Development Finance Corporation, the draft Guarantee Agreement between the Republic of Korea and the Bank, the Report of the Committee provided for in Article III, Section 4(iii) of the Articles of Agreement and the text of a draft Resolution approving the proposed Loan are being distributed to the Executive Directors separately.

20. The draft Loan and Guarantee Agreements conform substantially to the pattern of agreements for loans to development finance companies.

PART V - THE ECONOMY

21. A report entitled "Economic Position and Prospects of the Republic of Korea" (EAP-12a, dated March 16, 1970) was circulated to the Executive Directors on March 27, 1970. An updated economic memorandum and a basic data sheet are attached; they are based on information collected by an economic mission which visited Korea last September/October. In the light of this information and a review of the forthcoming Third Five-Year Plan scheduled by the Bank for next June, a new economic report is to be prepared in time for the next meeting of the Consultative Group in October 1971.

PART VI - COMPLIANCE WITH ARTICLES OF AGREEMENT

22. I am satisfied that the proposed Loan would comply with the Articles of Agreement of the Bank.

PART VII - RECOMMENDATION

23. I recommend that the Executive Directors approve the proposed Loan.

Attachments

Robert S. McNamara
President

April 13, 1971

BASIC DATA - REPUBLIC OF KOREA

<u>Area</u>	98,438 sq. km.		
<u>Population (mid year 1970)</u>	31.79 million		
Growth Rate (1970)	2.2% ^{a/}		
Density (per sq. km.)	323		
<u>Gross National Product</u>			
Total (1970 at current prices)	2,562 billicon won		
Annual average real rate of growth (1965-70)	11.3%		
Per Capita GNP (1970)	\$223 equivalent		
<u>Industrial Origin of Real GNP (1970)</u>	100%		
Agriculture, Forestry and Fisheries	26%		
Mining and Manufacturing	28%		
Economic Overhead and Construction	13%		
Other Services	33%		
(Wholesale and Retail Trade)	(17%)		
<u>Gross Domestic Expenditure</u>	<u>1965</u>	<u>1969</u>	<u>1970</u>
(current prices: as percentage of GDP)			
<u>Consumption</u>	94	84	84
Private	84	73	73
Public	10	11	11
<u>Gross Capital Formation</u>	14.8	30.4	26.2
<u>Gross Domestic Saving</u>	8.2	19.1	16.3
Private	(6.4)	(12.7)	n.a.
Public	(1.8)	(6.4)	n.a.
<u>Resource Gap</u>	6.6	11.3	9.9
<u>Public Finance</u>			
(current prices, in billion won)			
Current Revenue	91	370	n.a.
Current Expenditure	81	248	n.a.
Surplus	10	122	n.a.
Capital Expenditure	41	231	n.a.
Receipts from Counterpart Funds	33	17	n.a.

^{a/} This figure has not been adjusted by the result of the 1970 census, which shows an average annual growth rate of 1.9% between 1966 and 1970.

	<u>1965</u>	<u>1969</u>	<u>1970</u>
<u>Money and Credit</u> (annual rate of change in percent)			
Money Supply	33	46	41
Time and Saving Deposits	112	77	27
Total Bank Credit Outstanding	42	60	32
<u>Price Indices</u> (percent increase)			
Consumer Prices (Seoul)	13.6	10.1	12.7
Wholesale Prices	10.0	6.8	9.1
<u>Balance of Payments</u> (in million US\$)			
Merchandise Exports (f.o.b.)	175	658	882
Merchandise Imports (f.o.b.)	-416	-1,650	-1,761
Deficit	-241	-992	-879
Receipts from Military Expenditures	74	249	232
Other Services, net	- 27	- 51	-132
Balance on Goods & Service Account	-194	-794	-779
<u>International Liquidity</u> (in million US\$)			
Gross Foreign Exchange Reserves	146	550	606
Month's Imports of Goods & Services	4	3	3
IMF Quota	18.8	50	50
IMF Drawings (outstanding)	-	12.5	12.5
<u>Net Inflow of Foreign Capital</u> (in million US\$)			
Grants	203	244	178
Loans	-3	634	498
Direct Investment	-	16	65
Total	<u>200</u>	<u>894</u>	<u>741</u>

External Debt

Total outstanding external debt (disbursed) with maturity of over one year at the end of 1970: \$1,982 million

Amortization and interest payments on these debts during 1970 were estimated at \$321 million, or 23.4% of export earnings.

Exchange Rate (end December 1970). Banks' selling rate: 317 won to the dollar

April 13, 1971

UPDATING MEMORANDUM ON THE KOREAN ECONOMY

Economic Achievement

1. Rapid economic growth with strong emphasis on exports has been a basic objective of the Government's policy. With no scarcity of entrepreneurial talent and a well-educated and disciplined labor force, the private sector responded quickly to the opportunities afforded by the policy changes of 1964 that included major interest and exchange rate reforms and the subsequent Government emphasis on rapid industrialization. An aggressive export drive and a high rate of investment helped to transform the Korean economy. GNP increased in real terms by 11% a year during 1965-70, while GNP per capita rose by almost 9% a year to reach US\$223 in 1970. Exports rose from a low base at an annual rate of 40%.

2. The rapid growth has been concentrated in industry and infrastructure, which provided almost 60% of the increase in GNP since 1965. Industrial growth has been mainly in the major export industries such as textiles, plywood and more recently, wigs, the investment goods industries and such intermediate industries as chemicals, and petroleum and coal products. In addition to the stimulus of investment and export demand on industrial growth, there have been heavy public expenditures in infrastructure development, particularly ports, expressways and industrial complexes. The performance of agriculture, on the other hand, has been disappointing, with an average growth rate of 3-4% a year in 1965-69. As a result, Korea has had to rely heavily on imports of grains during this period to meet her food needs.

3. The population of Korea is about 32 million, of which some 37% are in urban centers. The population growth rate, restrained by an active official family planning program, declined from an average 2.8% a year in the first half of the decade to 2.2% in 1970. The economically active population increased at 2% a year during 1965-69 while employment increased at 2.6% a year. Thus, Korea has been able to expand its employment opportunities sufficiently to absorb the increase in the labor force and at the same time, reduce the level of unemployment from about 7.4% in 1965 to 4.8% in 1969.

Some Strains of Rapid Growth

4. While this unprecedented expansion in all phases of economic activity has led to greater prosperity, the benefits have been unevenly shared and the rapid industrialization inevitably has created considerable strains in the economy. The slow growth and adverse terms of trade in agriculture have meant a virtual stagnation of farm income since 1963. The average income of urban workers, on the other hand, increased by about 60% in the same period. Along with these income disparities, the

concentration of industrial development in urban areas and rapid growth of the urban population has led to traffic congestion, shortages of social services and housing and increased levels of pollution in major urban centers, particularly in Seoul.

5. While exports have been rising rapidly, both the expansion of investment demand at a rate greatly in excess of the rate of increase in domestic savings and the low domestic content of industrial production have caused an equally rapid increase in imports. Consequently, the foreign deficit increased steadily from \$194 million in 1965 to \$794 million in 1969. The external gap has been filled by an inflow of foreign capital. However, because of the decline in foreign official grants and loans, Korea has relied increasingly on commercial loans since 1967, which have led to a rapid increase in her debt servicing obligations.

6. Rapid income growth has also been accompanied by chronic excess demand which, in turn, has led to rising price and wage levels. During 1965-69 the Seoul consumer price index rose by 11.5% a year while the money wage of workers in the manufacturing sector increased by 24% a year. Wholesale prices in this period increased by about 23% in relation to external prices, whereas the exchange rate depreciated by only 10%. In these circumstances, export growth has relied increasingly on various incentives provided by the Government such as tax privileges, concessional interest rates, tariff exemptions on imported inputs, and the privilege of importing controlled items.

Efforts to Stabilize the Economy

7. Thus, Korea's outstanding economic performance has been achieved at the cost of moderate, but continuous inflation, a persistent balance of payments deficit and heavy external debt. Realizing the importance of keeping the external debt burden within manageable limits and of containing inflation, the Government in late 1969 adopted a set of monetary and fiscal stabilization measures that were designed to limit the growth of private consumption, curb credit expansion and to cut down the growth of imports and foreign borrowing. These policies were undertaken by the Government in agreement with the Fund and were specified in a Standby Agreement which contained annual ceilings on additional medium and long-term foreign borrowing and on domestic credit expansion.

8. The stabilization program has had significant effects on the economy in 1970, the most important being the fall in investment and foreign borrowing and the slow down in import growth. Fixed capital formation at constant prices fell by almost 2% and GNP at constant prices rose by 9.7%, as compared to 15.9% in 1969. The slower rise in GNP was partly due to stabilization efforts but was also partly because of the small increase in agricultural output from the large base of the 1969 bumper crop year. Imports of goods and services increased by only 10% in 1970, as compared with 25% in 1969. Exports jumped by 34%, al-

though part of this was offset by lower service receipts, so that the increase in the goods and services account was 19% in 1970. As a result, the deficit on the goods and services account was reduced slightly from \$794 million in 1969 to \$779 million in 1970. This was the first time since 1965 that there was not a sharp increase in the deficit. Foreign loans of more than one year maturity committed in 1970 amounted to \$544 million, which was considerably less than the \$916 million in 1969. At the end of 1970, Korea's total external debt amounted to about \$2 billion and the debt service ratio exceeded 20% (11% in 1969).

9. Despite the considerable efforts by the Government, however, the stabilization policies, while improving the situation, have not been sufficient to restore internal financial stability nor to ensure a more than temporary respite from the mounting requirements of external finance. Private consumption still rose by 11% in 1970, over 10% faster than GNP, and the price level went up by more than in 1969. The stabilization program has only temporarily eased the pressures on the country's external position. The pressures are likely to persist, for Korea's economy has become geared to a high rate of growth which cannot be slowed down abruptly without export and employment difficulties and other severe dislocation.

10. During 1971, the Government plans to continue its emphasis on export expansion while avoiding excessive increases in the external debt burden. The Government has set target increases of 10% for real GNP and less than 3% for gross investment. The Central Government's expenditure for 1971 is budgeted to increase by about 18%, with some of the increase allocated to defense in view of the partial reduction of U.S. forces. Because of the uncertainties in the world market and developments in Vietnam, the rate of increase in exports of goods and services is expected to slow down. The Government has recently agreed to limitations on new external debt and domestic credit expansion in the IMF Standby Agreement for 1971.

Longer Run Prospects

11. The Korean planning authorities' growth objective for the Third Five-Year Plan (1972-76) is 8.6% a year, a reduction from the 11% achieved in 1965-70. During the Plan period, particular attention will be given to the development of agriculture and the capital goods industry. The Government's objectives for agricultural development are to achieve foodgrain self-sufficiency and to raise farm incomes in the hope of reducing the present rural-urban income gap. By expediting the development of the capital goods industry, the Government hopes both to spur industrial growth and reduce Korea's present heavy dependence on imported capital goods. The Government will continue to give high priority to the rapid expansion of merchandise exports, having set the 1976 target at \$3.5 billion, which, together with a sharp reduction in the growth of imports, is expected to contribute to a substantial improvement in Korea's balance of payments position without leading to an increase in unemployment.

12. The projected growth rate seems likely to require a larger investment outlay than allowed for in Korean plans, and the Korean export goal may be too much to expect by 1976. On the other hand, Korean capabilities for economic growth generally, and for export expansion in particular, should not be under-rated, considering the record of rapid development and effective economic management in recent years. Nevertheless, formidable problems will have to be dealt with, especially in the promotion of exports and in the management of external debt.

13. Industrial products are expected to be the mainstay of further export expansion, and this raises the question of competitiveness of Korean manufactures. Substantial export subsidies are already required and industrial exports in the future will probably have to include heavier and more complex products for which Korean costs, relative to international costs, are likely to be higher, for a time anyway, than for the present pattern of manufactured exports. Thus, achievement of the export target will require additional measures of export encouragement.

14. Korea's requirements for external capital will continue to be high if rapid development is to be sustained, even if policies of restraint are pursued. The reasons for this are the high level of debt service that has already been reached, the wide gap that remains between savings and investment even after the impressive gains in savings to a level of 16% of GNP in 1970 (and the plan target of 21% by 1976), and the expected deterioration in the service account of Korea's balance of payments due to withdrawals of U.S. forces from Korea and Korean forces from Vietnam. A substantial reduction in the requirements for foreign resources cannot be achieved quickly without a sharp deceleration in the rate of investment, which, in turn, would have unacceptable consequences for employment, income and exports. Nevertheless, considering the past dynamic performance of the economy, the determination of Korea to pursue rapid development without excessive instability, and the capability and resourcefulness of both the public and private sectors, it seems reasonable to expect Korea to continue on its course of rapid economic development and it can be considered creditworthy for further Bank loans. Considering Korea's low level of per capita income and heavy dependence on foreign capital, some of the assistance from the Bank Group should continue to be on IDA terms.

April 13, 1971